UNIT 13: BUSINESS CYCLES

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Business Cycles

13.3.1 Meaning and Definition

13.3.2 Features of Business Cycles

13.3.3 Different Phases

13.3.4 Significance of the Phases

13.4 Causes of Business Cycles

13.5 Control of Business Cycles

13.6 Let Us Sum Up

13.7 Further Reading

13.8 Answers to Check Your Progress

13.9 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- describe the concept of business cycles and discuss the different phases of business cycles with their significance
- explain different features, causes and effects of business cycles
- put forward anti-cyclical measures.

13.2 INTRODUCTION

Economists have pointed out that a capitalist economy passes through certain phases. This means that even when a capitalist economy (for example economy of USA or the UK economy) experiences growth (growth in output, income and employment) over a longer period of time, there are some ups and downs in the economic activity of these economies. Interestingly, these ups and downs are recurring in nature;

more or less they occur at regular intervals; though the time period of their occurrence is not fixed.

Economists have termed such ups and downs as business cycles. Keynes used the term trade cycles instead of business cycles. The ups and downs have been divided into certain phases. This unit discusses meaning, definition, features and the various phases of this phenomenon. At the end of this unit, you will be able to forward some of the important anti-cyclical measures as well.

13.3 BUSINESS CYCLES

Business cycle is one of the complex phenomena that a capitalist economy faces. Economists have tried to explain this phenomenon from different perspectives. They seem to be divided equally while discussing the basic concepts like causes and phases as well. We shall however try to put forward the most common observations on the topic.

13.3.1 Meaning and Definition

Broadly speaking, business cycles are a kind of fluctuations which occur in business activities in an economy with a certain degree of regularity and which follows the different phases in certain sequence. Different economists have tried to define the term business cycles differently. In the following, we discuss some of the important definitions.

The definition put forward by Wesley C Mitchell and Arthur F Burns is considered to be the most comprehensive. According to them,

‘ Business cycles are a type of fluctuation found in the aggregate economic activity of nations that organize their work mainly in business enterprises : a cycle consists of expansions occurring at about the same time in many economic activities followed by similarly general recessions, contractions and revivals which merge into the expansion phase of the next cycle; this sequence of change

is recurrent but not periodic in duration; business cycles vary from more than one year to ten or twelve years; they are not divisible into shorter cycles with amplitudes approximating their own.'

This definition highlights the following points:

- Business cycles emerge in organised capitalist economies. Cyclical fluctuations are important features of such economies led by private entrepreneurs.
- Business cycles refer to the fluctuations in aggregate economic activity.
- The phases of expansion, recession, contraction and revival occur and re-occur in a definite sequence.
- The cyclical fluctuations are recurrent but not periodic. This means that they re-occur. But their re-occurrence does not follow a definite time-frame.

Keynes has defined business cycles (he used the term trade cycles) as "*A trade cycle is composed of periods of good trade characterised by rising prices and low unemployment percentages altering with periods of bad trade characterised by falling prices and high unemployment percentage."*

Haberler defines the term in these simple words: *"The business cycle in the general sense may be defined as an alteration of periods of prosperity and depression of good and bad trade."*

13.3.2 Features of Business Cycles

Business cycles are very complex phenomena to explain. However, some of the common features may be explained. Some of the features of business cycles are as follows:

- **Affect the Whole Economy:** Business cycles affect the whole economy. Business cycles often emerge in regular intervals and it affects all the sectors of an economy. Temporary and

partial fluctuations are not considered as trade cycles or business cycles.

- **Different sectors are affected with different intensities:** Even when all the sectors of the economy are affected by business cycles, during the phases of depression and prosperity, but all sectors of the economy do not feel the same pressures. For example, capital goods producing industries suffer more**.**
- **Irregular Time Duration:** A business cycle may complete its phases in a period of 5 to 10 years. Sometimes, this period may extend to more than 10 years while it may also last less than 5 years**.**
- **International by Character:** In today's age of Globalisation, countries of the world are closely connected with each other through international trade. As a result, prosperity or depressionary shocks in one part of the world affects all the countries. As a result, if depression emerges in a big economy, its repercussions are felt in many other countries of the world.
- **Recovery is comparatively slower than recession:** The trough of depression phases, (we shall discuss these phases in detail in the next sub-section) contains the vital seeds for recovery while the boom of expansion contains the germs of recession. But international experiences suggest that usually recovery is slower than recession.
- **Complex in Nature:** Business cycles are very complex phenomena to explain. Their emergence are results of specific factors. This is the reason, why all trade cycles do not have uniform characteristic and causes. Due to this reason it is difficult to make accurate prediction of trade cycles before their occurrence.
- **An Overall Growth Trend across different Business Cycles:** Even when the economy suffers from business cycles from time to time, as the market economy grows over a long period of time, there seems to be overall growth trend. This means that

the peak level of every next trade cycle occurs at a higher level of national income than the previous trade cycle**.** We have explained this phenomenon graphically in the next sub-section of this Unit.

- **Business Cycles affect beyond the Economy:** The affects of business cycles are not limited to economic activities only. In fact, they cause serious social consequences as well. It affects behaviour of people, and also results in increase in social crimes etc.

13.3.3 Different Phases

Business cycles consist of four phases viz., expansion (also called upswing or prosperity); peak (also called turning point or boom); contraction (also called downswing, recession or depression) and trough (also called lower turning point). We shall now consider the following figures depicting different phases of business cycles as has been shown in Figure 13.1. Then, we shall briefly discuss the significance of each of the phases.

Figure 13.1: Four Phases of Business Cycles without Growth Trend

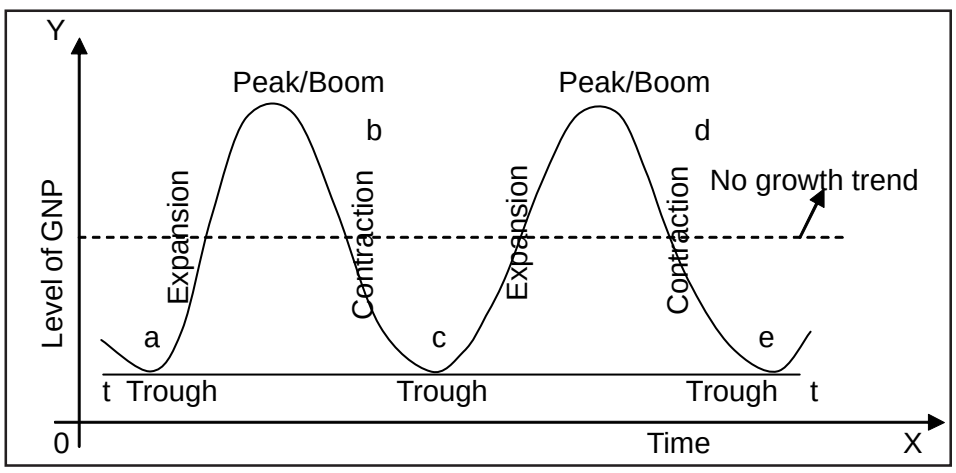


Figure 13.1 depicts the different phases of business cycles. From the figure it can be seen that the initial phase of the economy is at point a. This is termed as trough or depression. The economic activities (output, employment) are lowest at this level. With revival in the economy, the economy moves from a

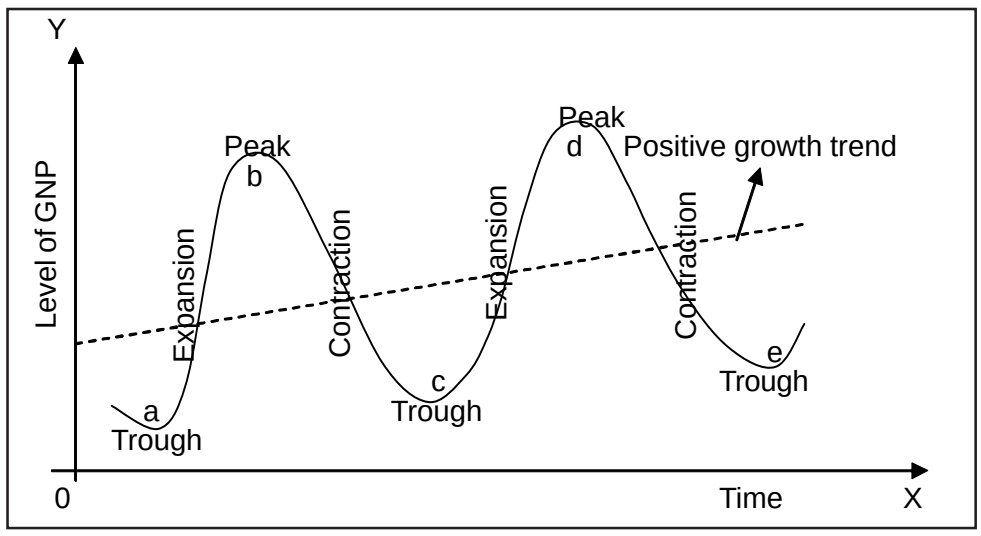
toward b. This is called expansion phase of business cycles. The economic activities prosper most during this phase. It reaches the peak level at point b. Level of output, employment and income all remain high at this stage. But the economic activities do not remain at such peak levels (we shall discuss its causes later while elaborating each of the phases) for all the time. The economy has to come down after some time. Thus, the economy activities gradually slow down and it moves from b to c. This phase (movement from b to c; i.e, until it reaches c) is called contraction. When the economy reaches its lowest level at c, it faces the stage of trough (or, depression) once again. This is just the repeat of the stage a. After the economy reaches the stage of depression, it gradually tends to recover and the business activities start to expand. Thus, the previous movement from a to b is repeated when the economy moves from c toward d. When it reaches the peak of the expansion phase at d, the economy grows to the highest level. After some time, it gradually starts to come down; which is simply the repeat of the previous stage from d to e. As it reaches point e, the depression phase of the economy is repeated once again.

Further, you will notice from the Figure 13.1 that as the economy passes though these phases, the overall economic activities have remained stagnant. This means that the level of output, employment and income has remained the same at each corresponding phases of the cycles. This can be found out from the fact that when the economy passes through the trough (depression) stages at different times viz., a, c and e, the level of economic activities has remained the same. This is obvious from the fact that all these points are tangent to the line tt parallel to the x-axis. This can be found out by drawing a parallel to the x-axis line through the mid-points of expansion and contraction phases of the business cycles as well. The dotted line in the figure thus, represents a dynamic stability i.e., no

growth trend over the years. No growth in output, employment and national income has been thus experienced over the period.

Contrary to this, economists like J R Hicks has pointed out even when the economy passes through these phases repeatedly, but they actually experience cyclical fluctuations rather than dynamic stability. This means, the level of economic activities do not remain the same over the years; thus, overall it grows. In such cases, when we depict a dotted through the mid-points of expansion and contraction phases, it will show positive growth in the economic activities. This has been shown with the help of Figure 13.2.

Figure 13.2: Four Phases of Business Cycles with Growth Trend



From the above figure 13.2 it is obvious that the economy passes through the same phases as it does in case of previous Figure 13.1. The only difference however in this case is that the dotted line drawn through the mid-points of expansion and contraction phases shows a positive growth trend. This means over the years, there is expansion in output, employment and income even when it passes through the same phases. Such movements of the business cycles thus depict cyclical fluctuations rather than dynamic stability.

LET US KNOW



It is to be noted that an economy may not follow each of the phases of business cycles in proper sequence as suggested by the curve of business cycles. Examples are available which show deviations from theoretical understanding of it. In 1929, the economy of England passed through Great Depression. Prior to the Great Depression, the depression phase of the England economy seemed to have stabled; thus, it should have actually moved towards expansion. But to the contrary, it moved towards the Great Depression. Again, the USA economy in 1937 once again moved towards recession (contraction phase) after it had recovered from the same phase.

Again, the time period of each of the phases is also not fixed. Sometimes, an economy may recover quickly, while at another instance it may require longer time to recover.

13.3.4 Significance of the Phases

Let us now discuss the significance of each of these phases in brief.

Expansion and Peak: During the phase of expansion, the economic activities start to expand. The level of output, income and employment rises. It gains the highest level of prosperity when it reaches the peak point of the business cycles. Economy reaches the highest level of national income. It means that there is no difference between the potential level of national income of the economy and the actual level. The demand for output (goods and services including durable consumer goods) reaches the highest level; it reaches the level of full employment as well.

However, the economy does not sustain at this level for good. It takes the turning point toward decline in economic activities. Economists differ regarding the possible causes for such down turn. Keynes has made falling MEC (decline in

expected rate of profit) responsible for this. ***Monetary economists*** point out that contraction in bank credit may be responsible for this.

Contraction: As stated above, the economic activities tend to decline. Thus, the level of employment, output and income declines. There exists large scale ***involuntary unemployment*** in the economy. The rate of interest also falls. As a result, people choose to hold cash in hand rather than keeping deposits in the bank. Industries accumulate a large volume of excess capacities as the level of production declines.

Trough or Depression: As the economy reaches the lowest level of economic activities, the economy reaches the phase of trough. The whole economy tends to break down during this phase. If sustained for a long time, it may lead to depression. The Great Depression of 1929-33 may be cited as an example which causes immense human suffering.

The depression phase of the economy will not however lead to prosperity automatically. If left at its own, the depression phase may sustain for an inordinately long period. The government must come to its rescue; it will have to undertake policies for the revival of the economy like stabilization policy, monetary measures like expansion of credit facility etc. such that the entrepreneurial spirit can be revived and promoted.



CHECK YOUR PROGRESS

Q 1: Match the following sets (A) with (B). Write the correct options in the alongside boxes.

Set (A)	**Set (B)**
(i) Expansion	(a) Turning point
(ii) Peak	(b) Boom
(iii) Contraction	(c) Lower turning point
(iv) Trough	(d) Recession

Q 2: Do you agree that the economy will automatically recover from the depression phase of business cycles? Give your arguments. (Answer in about 50 words)

.....

.....

.....

.....

.....

.....

13.4 CAUSES OF BUSINESS CYCLES

We have already mentioned that business cycles are complex phenomena. It is very difficult to list out the causes of its emergence. Even then, economists and others operating in the market have tried to list a few causes to its emergence. Some have tried to categorise them as monetary and non-monetary factors while others have tried to attribute them to psychological factors. Samuelson has pointed out two sets of factors responsible for the emergence of business cycles: external and internal. Let us dicuss these factors in brief.

External factors: External causes of business cycles emerge outside the economy and may range from sunspots, enviornmental disturbances, wars, revolutions, political events, gold discoveries, growth rate of population, migration, industrial discoveries and innovations etc. For example, political instability in a big influential economy may adversely affect the economic environment of that country along with the other economies who are closely linked with that economy in terms of international trade etc. An innovation like the railroads, telecommunication brought unprecendented business opportunites to the economies. Economic activities like investment, consumption saw mainfold increase with such innovations. Similarly, situations like wars, famine, major earthquakes etc. in one part of the world adversely affect the economic activities in the rest of the world often causing chain reactions in the global economy.

Internal factors: The internal causes of business cycles emerge from within the economy. Haberler has broadly classified them as monetary and non-monetary factors. The monetary factors include bank credit, over-saving or under-consumption and over-investment.

Monetary economists like Hawtrey, Friedman and others have pointed out that cyclical fluctuations are caused by expansion and contraction of bank credit. Expansion of bank credit leads to higher demand of goods and services while contraction limits the demand. Thus, they argue that increase in money supply (expansion in bank credit) brings prosperity and a decrease leads to depression.

Economists like Hobson, Foster and Douglas argue that over-saving or under-consumption leads to depressionary phase of an economy. They argue that the rich section of the people do not spend their entire income on consumption. As a result, they tend to save and invest more. This leads to over-production of consumer goods. The poor section of the economy on the other hand, though have higher propensity to consume, lack sufficient income in their hand to purchase the consumer goods. Thus, there is a supply and demand gap in the economy. While supply is more, demand tends to be less. As a result, stocks of consumer goods pile up. This further leads to fall in prices of consumer goods and the income of the producers. The final consequence is that depression sets in the economy.

Economists like Hayek, Cassel and Robertson makes similar arguments. However, they have pointed out that rather than under-consumption, it is over-investment that leads an economy towards depression. According to them, due to availability of bank credits, over-investment is experienced in capital-goods industries compared to the consumer-goods industries. As a result, money supply exceeds the amount of voluntary savings. While increased money supply leads to a boom phase in the economy, due to lack of voluntary savings, banks remain unable to supply sufficient credits for a longer period of time. In this way, over-investment leads to a depression in the economy.

The important non-monetary factors that cause business cycles include: macro economic environment, competition, psychological causes, innovations etc.

When the local and global macro economic environments are stable and pass through a boom phase, there is a general positive sentiment across the world economy. As a result, businesses in most of the countries experience a high demand and go into a high growth cycle. On the contrary, when global economy passes through an economic slowdown with cyclical unemployment, the general business environment also experiences a recessionary phase. This also adversely affects the local economy of the country. On the other hand, if the local economy (particularly, the major economies of the world) experiences serious economic downturns, they are bound to adversely affect the local businesses, even if the rest of the global economy is going through a growth cycle.

Chapman points out that competition may also lead to over-production, which ultimately leads to a depressionary situation. Pigou pointed out that psychological factors like 'over optimism' and 'over pessimism' lead to depression. According to him, over optimism of the business class leads to over-production in the economy, while over-pessimism leads to under-production. Pigou points out that these psychological factors of the business class act like alternating waves, and as a result of these reversals, business cylces occur in an economy.

Schumpeter points out that innovations in an economy are the sources of business fluctuations. In this regard he puts 'the cause of depression is prosperity'. He argues that innovations in one field leads to innovations in other fields. Soon, over-production results in the economy which further leads to depression.

13.5 CONTROL OF BUSINESS CYCLES

Different economists put forward different versions of remedial measures based on their arguments of trade cycles. Economists however agree that it is not always possible to avoid cyclical fluctuations in the economy fully. So, they argue that two sets of measures should be

adopted. Preventive measures may delay the occurrence of such phenomenon while curative measures will help the economy revive from the crisis.

Remedial measures for prevention of economic crisis depend on diagnosis of the crisis. Certain factors like change in climates or monsoon, availability of raw materials are highly unpredictable and can not be controlled. Again, the economic environment in an agrarian economy is bound to be different from an industrial economy. An agrarian economy however can reduce its dependence on climate through provision of adequate irrigation facilities. However, certain phenomena like drought, earthquake and epidemics can not be predicted with certainty.

The important economic variables like change in demand, export and import, per capita income, cost of living index, movement of prices etc., however, can be predicted much accurately if there exists a sophisticated and up-to-date statistical system. This may help business community to forecast economic variables to a large extent and follow business decisions accordingly.

The corrective measures on the other hand, can be discussed under the following heads:

Monetary Measures: As you have already known, monetary measures relate to the banking and credit policy of a country. Thus, the central bank of a country has very important role to play in setting the right kind of banking and credit environment of the country. The important measures of a central bank will be discussed in detail in the next course. We just simply mention in this unit that bank rate and open market operations are such two instruments. Thus, in boom conditions, the central bank raises the bank rate with a view to contract the credit supply in the economy. Again, during depression, a policy of cheap money may help stimulate business investment and thus recover the economy. Again, the central bank may also adopt sector-specific credit policies to promote certain sectors of the economy.

Economists however differ regarding the effectiveness of monetary policies to tackle cyclical fluctuations in the economy.

Fiscal Measures: We shall discuss in detail the important fiscal measures adopted by the government in the next course. Fiscal policy, in a wider sense, consists of public spending and appropriate taxation. Keynes was prominent to acknowledge the role of government spending during the period of depression. During depression government should spend beyond its capacity of revenue earning. This means that deficit budget is an important tool during depression. Such government investments are expected to raise the level of employment in the economy. In the long-run, as the economy recovers, the government should undertake budget-balancing measures to offset any adverse effects on the economy. Such measures will help the economy to stabilise in the long-run.

Again, the similar taxation policies are suggested:

- Tax structure and tax rates should be designed such that the business firms are motivated to undertake investment decisions.
- Government should provide employment benefits to the employees. This will help in boosting up the domestic consumption levels.
- Monetary measures should be suggested such that credit availability is enhanced.
- An appropriate international economic policy should be followed so that the domestic export sector is promoted.

International Measures: Business cycle is an international phenomenon and the fluctuations in a country will also affect other countries as well (especially in the present era of globalisation). Three measures are suggested to control depression phase of the business cycles (viz., international production control, international ***buffer stocks*** and international investment control). International production control tries to control the prices and production of primary products. Buffer stocks go hand in hand with production and price control. Buffer stocks mean holding stocks of primary commodities as a measure to wipe out price fluctuations. Thus, buying buffer stocks during slump or low-price and releasing the same when prices are high can help the economy ease

Buffer Stocks : and international investment control). International production control tries to control the prices and production of primary products.

out. Similarly, international investment controls are adopted to promote economic development of the backward regions of the developed economies. Such efforts have long-run effects on raising the living standard as well as reducing economic inequalities among the under privileged people.



CHECK YOUR PROGRESS

Q 3: State whether the following statements are True (T) or False (F).

(a) Preventive measures help the economy revive from depression. (T/F)

(b) Keynes was critical of government investment during depression. (T/F)

Q 4: Why are the international measures important in controlling depression? What international measures are generally adopted? (Answer in about 50 words)

.....

.....

.....

.....

.....



13.6 LET US SUM UP

- Business cycle is one of the complex phenomena a capitalist economy faces.
- Business cycles consist of four phases viz., expansion (also called upswing or prosperity); peak (also called turning point/boom); contraction (also called downswing, recession or depression) and trough (also called lower turning point).
- It is to be noted that an economy may not follow each of the phases of business cycles in proper sequence as suggested by the curve

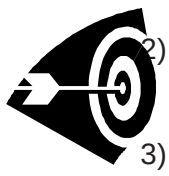
of business cycles. Again, the time period of each of the phases is also not fixed. Sometime, an economy may recover quickly, while at another instance it may require longer time to recover.

- Various measures are suggested for the prevention of and cure from cyclical fluctuations. Monetary measures like bank rate operations and credit control are important for the control of inflation. However, economists differ regarding the effectiveness of the monetary measures.
- Anti-cyclical fiscal measures consist of public spending and appropriate taxation. .



13.7 FURTHER READING

1) Ajuja, H.L. (2007) : Macroeconomics: Theory and Policy (Twelfth Edition). S.Chand & Co., New Delhi



2) Gupta and Rana (1997) : Keynes Post-Keynesian Economics. Kalyani Publisher, Jalandhar
3) Rana and Verma (1998) : Macroeconomic Analysis. Vishal Publications,Jalandhar
4) Shapiro, Edward (1988) : Macroeconomic Analysis (Fifth Edition). Galgotia Publications pvt.ltd

13.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No. 1:

Set (A)	**Set (B)**
(i) Expansion	(b) Turning point
(ii) Peak	(a) Boom
(iii) Contraction	(d) Lower turning point
(iv) Trough	(c) Recession

Ans to Q No. 2: The depression phase of the economy will not automatically recover. If left at its own, the depression phase may sustain for an inordinately long period and this may ruin the whole economy. The government must come to its rescue, especially for the revival of the economy through adoption of stabilization policy, monetary measures etc.

Ans to Q No. 3: a) False b) False

Ans to Q No. 4: Business cycles is an international phenomenon and the fluctuations in a country will also affect other countries as well (especially in the present era of globalisation). This necessitates adoption of international measures for the control of business cycles.

Three measures are suggested to control depression. They are a)international production control b) international buffer stocks and c) international investment control.



13.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What do you mean by business cycles? Briefly discuss its various phases.

Q 2: Discuss the various phases of business cycles.

Q 3: Enumerate the significances of various phases of business cycles.

Essay-type Questions (Answer each question in about 500 words)

Q 1: What do you mean by business cycles? Suggest important anti-cyclical measures.

*** ***** ***